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SUBJECT: BULGARIA'S EU ENTRY HELPS MANY - BUT NOT ALL

REF: SOFIA 0473

1. (SBU) SUMMARY: Bulgaria entered the EU in strong macroeconomic and fiscal shape with 5 percent annualized GDP growth over the past 7 years and three years of budget surpluses. Foreign investors are piling in to take advantage of cheap prices and labor, much as they did in the EU-10 a few years ago, seeing - or hoping to see - Bulgaria as a more stable business environment under Brussels' wing. Increased free trade with the EU brings more competition to Bulgarian companies, improving quality and lowering prices for customers, but will also force weaker firms out of the market. U.S. business interests will benefit on-the-whole from a larger, more transparent, and better-regulated market, but EU-specific non-tariff barriers will adversely affect U.S. agricultural sales here. In the "victim-of-their-own-success" category, excess demand for high-skilled labor is already creating a shortage of specialists in the high-tech sectors. EU membership is clearly positive overall for the Bulgarian economy, but not everyone will win. END SUMMARY

INCREASED EU INTEGRATION TO BENEFIT MANY. . .

2. (U) Bulgaria's current trade with the rest of the EU is over 50 percent of its total trade, and will grow significantly given the new tariff-free environment. New companies and imported goods and services will bring more competition to the local market, benefiting local customers and producers with higher-quality products at lower prices. Bulgarian exporters are expected to take advantage of new opportunities in the EU to improve export growth even further over last year's record 26.6 percent increase. Bulgarian citizens will also benefit from new safety regulations for goods in food and non-food sectors.

. . . BUT ONLY THE FITTEST WILL SURVIVE INCREASED COMPETITION AND REGULATION

3. (SBU) EU structural aid in the pre-accession period tried to prepare local industries and companies for the challenges of EU competition. While the bigger companies took advantage of this to replace old equipment and technology to meet EU market criteria, many smaller companies lacked the necessary resources. Those that manage to restructure will be able to utilize economies of scale. But the smaller, and often unprepared, companies will face serious hardships from rising EU competition. The regulatory changes will also cut both ways; some will meet the new requirements and attract further investment, while others will be swamped by EU red tape and its Bulgarian corollary, corrupt officials taking advantage of new laws and regulations. There are concerns about the potential for biased enforcement of environmental standards - already a problem here. The new European energy strategy aimed at greater efficiency and competition will increase the compliance cost for many local businesses. Farmers in the heavily subsidized agricultural sector are likely to be most squeezed by the growing EU competition, and many will struggle to survive by relying on EU funds.

GROWING NUMBER OF U.S. INVESTORS, AGRICULTURAL HARDSHIPS

14. (U) U.S. investors continue to find new opportunities to invest in Bulgaria, with U.S. FDI increasing 63 percent to \$116 million in 2006 over \$71 million in 2005. (Bulgarian government statistics do not reflect true U.S. investment levels as many are made through another European subsidiary, i.e. Austria has appeared as a much larger investor in terms of FDI because U.S. companies used Austrian holding companies to invest in Bulgaria - usually for tax reasons.) Much of U.S. investor interest was pre-EU accession money trying to get in early, but we have seen continuing interest from U.S. players, including the recent AIG purchase of a controlling stake in the national telecom provider for \$1.4 billion. An additional stimulus comes from the February 2007 signing of the bilateral double taxation treaty, which will create a more favorable tax situation for American investors. While the general tariff level for U.S. imports to Bulgaria has decreased due to EU accession, U.S. agricultural exports will continue to face high heavy non-tariff barriers, especially EU standards on imported meat and nuts. In addition, EU food safety standards will hit hard U.S. beef and poultry exporters.

LABOR SHORTAGES FOR MOST SKILLED

15. (U) Bulgaria's labor costs are cheap enough -- reflecting relatively low productivity and salaries -- to attract new foreign companies. The Bulgarian economy can capitalize on this competitive edge for some time, but the need for high-skilled workers and mid-level managerial staff has become a problem already for some high technology and innovative companies. Excess demand has pushed company owners to significantly increase remuneration packages and recruit qualified personnel from abroad. Tourism, construction, and retail have also started to report shortages of trained staff. Given the already large movement of labor out of Bulgaria in the

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past 15 years, the gradual liberalization of the EU labor market is not expected to lead to another mass migration of domestic specialists. But some sectors, such as health and textile, could lose qualified workers to other EU countries due to higher wages.

GRADUAL, BUT UNEVEN, INCREASE IN PRICES

16. (U) Economic and monetary convergence with the EU will likely lead to an increase in domestic prices, but their rise will be gradual, reflecting a relatively low base of household incomes and purchasing power, according to the National Statistics Institute. The duty-free import of fruit and vegetables from the EU and their seasonal domestic supply will keep prices relatively low. Prices of meat and milk will see some increase in the short run due to the shortage of domestic supply (for meat) and quality (for milk) and the increasing cost of modernization to meet EU standards. Prices of some industrial goods (clothing, home appliances) will fall due to reduced tariffs and third-country competition (China, India). Prices in education and healthcare, the two most unreformed public realms, will increase. The 4.2 percent rise in prices since January suggests that control over inflation will remain the government's major economic concern prior to adoption of the euro. The government will be keeping a close eye on reports from private sector analysts that the economy is heating up too quickly. Pensioners, on fixed-income, and those in small rural settings will particularly be hard hit as inflation eats at their small monthly intake.

17. (SBU) Bulgaria is expected to hew fairly close to the EU party line on issues such as the Doha round, Common Agricultural Policy, and geographic indicators. Although the current center-left government (and most of the non-reactionary rightist opposition) tends to be more liberally-minded on economic issues than some of the more senior Member States' leaders, Bulgaria - as the poorest EU Member State - will not be biting the hand that feeds it. We are trying, however, to encourage Bulgaria to take a more active role on energy security issues, taking advantage of their location as a gas and oil pipeline crossroad, and their historical, cultural and business relationships with Russia.

18. (SBU) Uliana Bogdanska, the head of the Foreign Ministry's EU directorate, told us recently that energy issues are a high priority for Bulgaria and that Sofia is trying to be an active participant in forming the EU's common energy policy. She said Bulgaria agreed with most of the decisions taken at the GAERC meeting in March, which focused on a forging a common energy strategy. Bulgaria was particularly happy to see that nuclear energy was recognized as reducing greenhouse gases given the large role nuclear power plays in the country. Vladimir Stariradev, the Director for Energy Strategy at the Economy and Energy Ministry, explained to us that Bulgaria welcomes "in principle" the EU's target of using 20 percent of renewables by 2020, but believes this should be done in a "cost-effective" way. Stariradev expressed Bulgaria's concern that an excessive share of renewables could reduce the country's economic growth, noting that such targets should not be binding "because different countries are starting from different places." According to Bogdanska, Bulgaria was pleased the Nabucco pipeline was identified as one of four key priority projects that the EU intends to explore for increasing energy diversification. Bogdanska expressed hope that the EU will put funds forward for the project.

19. COMMENT: (SBU) Bulgaria's stable macro-economic indicators, low-risk profile, and mainly successful transition to the European market will benefit U.S. investors who are increasingly eyeing the Balkan state following its EU accession. But Bulgaria's economy will suffer competitive pressure long after its accession due to low productivity and relatively low export level. Key to a successful export promotion strategy will be the use of high-skilled and more efficient labor, now producing at only a third of the EU average. EU accession can be a great opportunity for Bulgaria if it takes full advantage of improved oversight, EU support mechanisms, and the real chance to show its citizens that there are better, cleaner and more efficient ways to improve their quality of life. They won't be leading the charge in Brussels, but they will work on a few issues, some of which dovetail with our interests. END COMMENT
KARAGIANNIS